VZCZCXYZ0001
RR RUEHWEB

DE RUEHSN #0479/01 1092214
ZNR UUUUU ZZH
R 182214Z APR 08
FM AMEMBASSY SAN SALVADOR
TO RUEHC/SECSTATE WASHDC 9352
INFO RUEHZA/WHA CENTRAL AMERICAN COLLECTIVE
RUCPDOC/USDOC WASHDC
RUEATRS/DEPT OF TREASURY WASHINGTON DC

UNCLAS SAN SALVADOR 000479

SIPDIS

STATE PASS USAID/LAC
STATE ALSO PASS USTR
USDOC FOR 4332/ITA/MAC/WH/MSIEGELMAN

SIPDIS

E.O. 12958: N/A
TAGS: ECON ETRD EINV ES
SUBJECT: INFLATION IN EL SALVADOR: PERCEPTION VS. REALITY

¶1. Summary. Officially, El Salvador has the lowest annual inflation rate in Central America, but public perception is the cost of living is rising dramatically. El Salvador's Consumer Price Index (CPI) is based on 17-year-old consumer data, and critics believe that it understates actual inflation. Although the overall trend in inflation is likely still sound, economists agree that El Salvador starts from the highest base prices in the region, so even low inflation has a big effect on consumer confidence. In the run-up to 2009 elections, public perception of inflation is likely to drive additional populist economic policies with negative long-term effects. End Summary.

Inflation Today

¶2. The official inflation rate in El Salvador remains the lowest in Central America, at 4.9% in 2007. The average annual inflation rate from January 2000-February 2008 was 3.5%, compared to 7.2% for Guatemala, 8.2% for Honduras, 8.5% for Nicaragua, and 11% for Costa Rica. In March 2008, El Salvador's inflation rate rose to 6%.

¶3. Public perception of inflation, however, is far different. In a recent poll conducted by national newspaper "La Prensa Grafica," 84 percent of Salvadorans think that the cost of living in the country is bad or very bad. Complaints about the rising cost of living are commonplace, and increases in the price of gasoline and the price of beans make the front page of the national press.

Official Measures of Inflation

¶4. The Census and Statistics General Directorate of the Ministry of Economy (DIGESTYC) compiles the official consumer price index (CPI). According to Miguel Angel Corleto, director of DIGESTYC, The CPI uses a market basket based on a 1990-1991 Expenditures & Income Survey, with a base of December 1992. This basket is composed of 241 goods and services which reflect the average patterns of consumption of an urban household of 3.9 members. In this index, foods and beverages have a weight of 33.49%, while transportation has a weight of 10.35%.

¶5. With the assistance of the Swedish Agency for International Development, DIGESTYC is developing a new CPI based on the Expenditures and Income Survey of 2005-2006. DIGESTYC began internally tracking the new CPI in September 2007 and will replace the current CPI in January 2009. According to DIGESTYC, the new CPI is a higher quality index with improved geographical coverage and content. The index will maintain the same number of goods and services (241), but the specific goods and services are updated to reflect current consumption. For example, it drops black & white TVs and wax candles and adds cell phones and cable TV service.

According to DIGESTYC, the results of the current and the new CPIs are similar, demonstrating the same overall trends.

¶6. DIGESTYC also tracks a "basic basket" for both urban and rural areas. The basic basket is based on a nutritionist's assessment of the minimum caloric and nutritional requirements for an urban or a rural Salvadoran family. These nutritional requirements are then matched up against "typical" food products, which form the basic basket. Because the basic basket is derived from nutritional requirements rather than consumption surveys, it does not necessarily reflect actual consumption or goods purchased. Regardless, the basic basket is widely cited as a measure for cost of living, especially for the poor.

Criticisms & Causes

¶7. The most common criticism of the CPI is that it is a dated measurement that doesn't reflect El Salvador today. According to Dr. Roberto Rubio, head of the moderate-left NGO Foundation for Development (FUNDE), the current CPI is too dated in both its products and in the weight given to different parts of the basket.

Armando Flores, director of the private Consumer Defense Center (CDC), goes one step further, arguing that national statistics are fundamentally flawed and therefore the official inflation rate is questionable. Using their own measure, the CDC estimated that the price of the rural basic basket increased by 27% and the urban basic basket increased by 25% between May 2004 and January 2008, and difference between rural and urban appears to be gowing in 2008. Prices of key staples greatly inceased during 2007. For example, the price of beas increased by 68%, the price of rice by 56.2%, and the price of corn by 37.5%. Flores noted that te current rural minimum salary only covers aroun 72% of the rural basic basket, while the urban inimum salary covers around 120% of the basic baket. According to World Food Program estimates, the actual

calorie intake of an average meal in rural El Salvador today is roughly 60% of what it was in May 2006, leading to increased under-nourishment.

¶8. According to Alvaro Trigueros Arguello, Macroeconomic Section Manager, and Rafael Pleitez Chaves, Social Section Manager at the Salvadoran Foundation for Economic and Social Development (FUSADES), El Salvador's most prominent think tank, DIGESTYC's figures are good, but the cumulative effect of inflation has taken a toll on people's pocketbooks. Arguello noted that, by official measures, the cost of living has gone up 19.5% over the last four years, so public perception is not necessarily inconsistent with official figures. According to FUSADES public opinion research, there is also a strong correlation between higher gasoline prices and lower consumer confidence.

¶9. Former Finance Minister Manuel Enrique Hinds also attributed most of El Salvador's inflation to external factors, primarily world commodity prices. He saw a strong correlation between the U.S. current account deficit and commodity prices, which he thought would correct as the current account deficit fell. Nevertheless, Hinds expected commodity prices to remain high for at least 2 to 5 years. In his view, rising food prices were the biggest single threat to El Salvador's economy, but there was "nothing" the government or other actors could do.

¶10. DIGESTYC, Rubio, and Flores all agreed that one reason Salvadorans perceive inflation to be high is that El Salvador starts from the highest prices in the region. A 5% increase in prices in El Salvador will therefore be felt a lot more than a 10% increase in neighboring Honduras, where most prices are lower. Rubio and Flores both blame the lack of competition in El Salvador, especially an oligopolistic market in several sectors (air transportation, cement, flour, and beer), for the higher prices. DIGESTYC attributed the higher prices to the need for El Salvador to import most of its products.

¶11. Many in the public blame dollarization for higher prices. Rubio said that the higher initial prices in El Salvador have been more noticeable since dollarization, which is why people associate higher prices with dollarization. Beyond some "rounding" when prices were

dollarized in January 2001, however, none of the think tanks or economists attributed inflation to dollarization.

¶12. FUSADES has been developing a theoretical model that tries to explain the relationship between inflation rate, exchange rate/dollarization, and remittances. Looking at the last seven years, they found that inflation is primarily a function of three factors: "imported" inflation from the U.S., oil prices, and remittances. According to their model, the growth of remittances explains a major part of the changes in the inflation rate in El Salvador, and as the rate of remittance growth decreases, El Salvador's inflation rate should converge with the U.S. inflation rate.

Comment

¶13. El Salvador's official inflation rate is based on a dated CPI, and the actual inflation rate is likely somewhat higher than official statistics. Nevertheless, under a new measure, El Salvador's inflation rate should still be the lowest in the region. As a dollarized economy, El Salvador avoids politically motivated, inflationary monetary policy, a fact noted by economists on both the left and right. Likewise, the main factors driving inflation - higher international oil and food prices - affect the entire region. El Salvador does, however, have among the highest prices in the region on many goods, and so even a small increase in inflation is noticed by the public. Further, consumer take little solace in knowing that prices they are paying may be going up slower than prices in neighboring countries. What they tend to focus on is that prices are going up, and in certain instances way up.

¶14. Public perception of the cost of living is unlikely to change in the near future, and the real risk is that this will lead the government to implement unsound economic policies in an effort to "do something" before January and March 2009 elections. President Saca's description of a "perfect storm" of slower U.S. growth and high energy and food prices could presage further government intervention. Already the government has adopted some price controls/price freezes in sectors like electricity and introduced untargeted transportation subsidies that economists across the political spectrum deride. In the longer term, these policies distort the market and may have a negative effect on foreign investment. If food and oil prices continue to rise, it is probable that we will see additional, politically motivated economic policies trying to shore up consumer confidence and ARENA's electoral prospects.

Butler